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TAGS: EFIN ECON EINV BU
SUBJECT: BULGARIA: ECONOMIC CLOUDS ON THE HORIZON, BUT TOO EARLY TO PREDICT A STORM

¶1. (U) SUMMARY: Having already risen above the 2005 forecast of 3.5 percent, Bulgaria's inflation rate is expected to jump dramatically to 8.4 percent in the first quarter of 2006 thanks to higher fuel prices and an increase in excise taxes to match EU minimum levels. However, inflation is expected to fall in the second half of 2006 and further decline in 2007. Apart from inflation, the GOB in 2006 will have to contend with the economy's two other major problems--the soaring current account deficit of 14 percent of GDP for 2005, and increasing external debt of 63 percent of GDP. The government's tight fiscal policy and central bank's restrictions on bank lending are cooling growth in domestic demand, resulting in an estimated overall GDP growth of about 5.5 percent for 2005. Despite the stalled privatization process, investment activity has remained strong. Foreign direct investment (FDI) is estimated to top two billion euro in 2005, spurred by a higher number of green-field investment projects. With average monthly wages still at about USD 200, the government is under pressure to raise wages, but must balance calls for a wage hike with the need to maintain tight fiscal policy and keep inflation under control. END SUMMARY.

UPWARD PRICE MOMENTUM

¶2. (U) Bulgaria's inflation rate is likely to exceed the official forecast of 3.5 percent for 2005 and is predicted to spike in the beginning of 2006. Between January and November 2005, the consumer price index posted a 5.6 percent increase. The rise in prices was caused by higher prices for food (as a result of the recent floods), electricity, heating, and fuel (due to global oil prices rise). Price pressures have led the central bank to forecast a worrying inflation rate of 8.2-8.4 percent in the first three months of 2006 on a year-on-year basis. The higher price level in 2006 will be primarily driven by higher excise taxes. The Bulgarian parliament recently approved amendments to the excise tax law confirming the government's plan to introduce the EU minimum excise tax levels before the country joins the EU. As a result, the prices of cigarettes, spirits and automobile fuel will increase by 65 percent, 17 percent and 4.6 percent, respectively.

¶3. (U) Despite an initial jump in inflation, the government is forecasting an overall inflation rate of 4.9 percent for ¶2006. Independent observers believe, however, that the government's move to initiate the excise tax increases will keep inflation above 5 percent over the next year. After a rise in early 2006, inflation is expected to decline considerably into 2007, as the price shocks linked to meeting the EU minimum levels of excise taxes will not be repeated and anticipated falling oil prices will also reduce external inflationary pressures.

¶4. (U) Despite the price push, the central bank has welcomed the government's plan to conform to the EU levels of excise taxes. The central bank believes the inflation target will be the most difficult EU convergence criteria to fulfill because of the lack of independent monetary policy and control over inflation, the result of a currency board arrangement.

CURRENT ACCOUNT AND EXTERNAL DEBT REMAIN MAIN CONCERN

¶5. (U) High oil prices and strong domestic demand have contributed to a sharp increase in Bulgaria's current account deficit during the first ten months of 2005 -- to 2.2 billion euro or 10.5 percent of GDP, as compared to 918 million euro or 4.7 percent of GDP last year. As a result, the deficit for the year as a whole is expected to be about 14 percent or 2.9 billion euro. Finance Minister Oresharski has said the chronically high current account deficit is the government's biggest concern and the GOB will seek to limit the deficit to 12 percent by the end of 2006. According to the press, the government may have to resort to some drastic measures--such as freezing wages and increasing the VAT--if the problem persists.

¶6. (U) Bulgaria's gross external debt has been increasing throughout the year due to an increase in private foreign debt. In October 2005, gross foreign debt stood at 13.4

billion euro or 63 percent of GDP, up by seven percent or 888 million euro relative to December 2004. In contrast, the government's well-managed debt policy has lead to a substantial decrease in the stock of government debt. Thanks to the two Brady Bond buy-back deals, foreign government debt stood in October 2005 at 6.9 billion euro or 32 percent of GDP. Next year the government foreign debt is expected to decline further as the Finance Ministry carries out its plan to retire part of IMF/WB debt in January 2006.

GDP GROWTH LOSES STEAM IN THIRD QUARTER

¶7. (U) Following a record-high GDP growth of 6.4 percent in the second quarter of 2005, Bulgaria's GDP growth slowed to 4.6 percent in the third quarter of 2005. The primary cause of the slowdown was a sharp decline in agriculture production, a result of the devastating floods in the summer and early fall of this year. Agriculture production in the third quarter dropped 6.6 percent relative to the same period last year. This decline was offset by growing industrial production (up 6.5 percent) and services (up 4.8 percent). With a GDP growth of 5.6 percent from January to September 2005, the central bank continues to estimate total GDP growth for 2005 at 5.4-5.8 percent. While the government economic program calls for a slightly lower real GDP growth of 5.5 percent, other independent observers believe GDP growth will reach 5.7 percent.

SHIFTING FOCUS TO GREENFIELD INVESTMENT

¶8. (U) New foreign direct investment (FDI) in the period of January through October 2005 increased by only five percent--to 1.466 billion euro--compared to the same period last year. The decline is due to a halt in the privatization process. To date this year, there has been no foreign investment linked to privatization, as compared to 325 million euro spurred by privatizations for the same period in 2004. The Bulgaria Investment Agency (BIA) estimates FDI of more than two billion euro for 2005 thanks to the expansion of existing foreign investment as well as the green-field investment projects to be completed by the end of the year. The largest sources of this new FDI are Austria, with 31.5 percent, followed by U.K. and Switzerland. FDI covered 66 percent of the current account deficit.

UNEMPLOYMENT HISTORICALLY LOW

¶9. (U) The latest labor market data continue to demonstrate the trend of falling unemployment. According to the Ministry of Labor and Social Policy, unemployment hit a ten-year low of 10.4 percent (383,930 unemployed) in November ¶2005. The positive employment trend is largely attributable to the larger number of people who started work under government sponsored employment programs. Despite the encouragingly low level of unemployment, the regional breakdown shows that the unemployment rate continues to vary widely throughout the country. While in major cities the unemployment remains low as compared to the national level (2.9 percent in Sofia for example), there are other regions with double-digit unemployment: Turgovishte-22.9 percent; Montana-20.9 percent; Vidin-19.5 percent; Razgrad-17.8 percent; and Shoumen-17.4 percent.

BUDGETARY SURPLUS; DECLINE IN CREDIT GROWTH

¶10. (U) The Bulgarian government's measures to curb buoyant domestic demand include a tight fiscal policy and credit growth restrictions. The government originally planned a budget deficit of 0.5 percent of GDP in 2005, but agreed with the IMF to target a surplus of one percent of GDP in order to prevent domestic demand from overheating. The Finance Ministry estimates that the 2005 consolidated budget will run a surplus of two percent of GDP (about 500 million euro). In October 2005, the consolidated budget registered a surplus of one billion euro.

¶11. (U) The measures the central bank took earlier this year have been successful in moderating credit growth. The growth rate in non-government sector credit slowed to 32.5 percent in the period between January-November 2005, and is most likely to reach the targeted rate of 30 percent by the end of the year. The additional measures introduced by the central bank in November 2005 will lead to a further drop in credit growth, with a target of 16 to 20 percent for 2006, according to the central bank. However, non-bank financial institutions - called "leasing companies" in Bulgaria - have to some extent offset the central bank's efforts to restrict credit.

COMMENT

¶12. (SBU) While the GOB's efforts to stem bank credit growth

have been effective, the IMF is still expected to continue to pressure Bulgaria to maintain tighter fiscal policy and a budget surplus of three percent to counter its growing current account deficit. We will continue to pay close attention to the GOB's ongoing negotiations with the IMF, especially after parliament in December passed a balanced 2006 budget despite IMF insistence on a surplus. Although the government is resisting certain pressures from the IMF, the center-left ruling coalition, led by the Bulgarian Socialist Party (BSP), has demonstrated its resolve to preserve macroeconomic stability and keeping the economy growing. The GOB's chief economic policy priorities now are to maintain fiscal discipline, attract higher inflows of foreign green-field investments and prepare the country to meet EU convergence criteria. The government, however, needs to re-energize the privatization process and work with the IMF to institute the right mix of economic policies to adequately address Bulgaria's looming current account deficit and growing external debt. End Comment.

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